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11. (U) Provided below is Embassy Buenos Aires' Economic and Financial Review covering the period June 12-27, 2007. The unclassified email version of this report includes tables and

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charts tracking Argentine economic developments. Contact Econoff Chris Landberg at landbergca@state.gov to be included on the email distribution list. This document is sensitive but unclassified. It should not be disseminated outside of USG channels or in any public forum without the written concurrence of the originator. It should not be posted on the internet.

Highlights

-- FATF approves Argentine terror finance law
-- Energy Shortages Continue
-- GDP growth and industrial production decelerate
-- Strong May primary fiscal surplus thanks to pension funds transfer

Banking and Finance

FATF approves Argentine terror finance law

12. (SBU) On June 27, member countries of the Financial Action Task Force (FATF) agreed during the ongoing plenary in Paris to accept the enactment of Argentina's counter-terrorism

finance (CTF) law as adequate to end FATF's multi-year follow-up process on this issue. With this decision Argentina will no longer face the possibility of FATF sanctions over its non-compliance with FATF's terrorism finance requirements. During the plenary meeting, GoA officials stated that the GoA expected to publish the law next week in the Official Gazette, and it would enter into force eight days after the date of publication.

¶3. (SBU) As reported in past Reviews, the Argentine Congress has been reviewing the GoA's draft counter terrorism and counter terrorism finance law since President Kirchner submitted it to the Senate on December 20, 2007. During FATF's last plenary, in February 2007, FATF members gave the GoA until the June 25-29 plenary to pass the legislation, or face the possibility that FATF would issue a public statement of non-compliance. After several months of inaction, the Senate passed the bill on June 6, followed rapidly by passage on June 13 in the Chamber of Deputies.

¶4. (SBU) Despite some weaknesses, this law represents an improvement to the legal and regulatory framework. Argentine lawyers generally argue that the current penal code is sufficient to address any crime that could fall under the definition of terrorism or facilitating terrorism, and argue that the main benefits of this law are to send a signal and to provide the legal foundation for the Central Bank and Financial Investigative Unit's enforcement measures.

¶5. (SBU) The law is not without its detractors. The vocal human rights NGO, "CELS" (Centro de Estudios Legales y Sociales), has criticized the legislation, alleging that the Congress rushed passage only to fulfill the FATF requirement, and did not give it adequate review. CELS argues that the law is ambiguous and leaves it open to abuse with respect to

protection of human rights.

Energy

Energy Shortages Continue

¶6. (SBU) Natural gas and electricity shortages continue to be front page news in Argentina, and are impacting industrial production, government operations, and possibly even sovereign bond prices. Most analysts consider this a temporary energy "crunch," and not the beginning of an energy crisis for the time being, and expect warmer weather would be enough to alleviate the problem. The colder than normal weather recently, coupled with lower hydroelectric output (due to below-average rainfall and runoff from snowcaps), exposed the real crisis -- inadequate energy sector infrastructure. These supply bottlenecks will likely cause shortages and rationing, particularly during summer and winter peak usage periods, for years to come.

¶7. (SBU) The culprit is the lack of investment that began in the late 1990s and was exacerbated by the 2001/2002 crisis and subsequent government price freezes and controls, and this is unlikely to change until the GoA adjusts its energy sector policies. So far, the GoA has dealt with the problem through rationing and short-term fixes (such as rationing, reducing government operations, and consumer education programs on energy conservation). The GoA has enforced the rationing primarily on the industrial sector and has prioritized energy supplies to residential areas. Many industries are coping with the shortages by shifting production to periods when residential demand is low.

Economic Outlook

GDP growth and industrial production decelerate

¶8. (SBU) Industrial production (IP) increased a modest 0.4%

m-o-m and 6.4% y-o-y in May, disappointing the market, which forecast a 6.9% y-o-y increase. The soft May reading was not the result of the GoA's recent rationing of natural gas and electricity, as local media have erroneously reported. Rather, it is largely explained by labor strikes over higher wages, technically scheduled work stoppages for maintenance, as well as by two holidays that shortened production schedules during May. The negative impact of energy rationing is yet to come, and will be felt strongly in June-August (usually the coldest months in the southern hemisphere). The GoA also reported an increase of only 0.2% m-o-m in April of the seasonally adjusted EMAE index (estimador mensual de actividad economica), a proxy for GDP growth. This was lower than the 0.6% seasonally adjusted average increase in the first quarter of the year, and may be an indicator that overall growth is slowing. Nevertheless, the index increased 8.4% on a year-on-year basis, driven mainly by the services-related sectors, such as financial services, retail and wholesale trade, and transport and communication.

¶9. (SBU) This winter's colder than normal weather and lower hydro output could accelerate the decline of IP and GDP growth. As reported in the last Review, many local analysts

predict growth to decelerate further in coming months due to the energy shortages, with the worst case scenario of a reduction in 2007 real GDP growth of one to two percentage points. However, other analysts discount their impact and argue that the expected weaker performance of the manufacturing (industrial) sector (which represents about 22% of GDP) will be at least partly offset by expected record grain harvests this year. Even so, energy sector problems have ancillary costs, including increased power generation expenditures (through use of diesel generators), increased government subsidies (that primarily benefit residential consumers, and which will worsen GoA fiscal performance), and higher fuel imports (which could dent the trade surplus). The media also reports that Argentina's bond prices have fallen, as the market adjusts downwards its expectations of future growth, so the GoA's cost of financing could also worsen.

Strong May primary fiscal surplus thanks to pension funds transfer

¶10. (SBU) The GoA announced June 21 a record monthly primary fiscal surplus of ARP 5.3 billion (\$11.7 billion) for May, a 37% y-o-y increase. The primary surplus for the first five months of 2007 was ARP 12 billion (almost \$4 billion). The strong result in May is explained by rising tax collection (up 30% y-o-y) and an extraordinary ARP 1.5 billion (roughly \$500 million) transfer from the private pension funds to the GoA as part of the counter-reform of the pension system (explained below). The higher surplus also comes in the face of rapidly increasing primary and capital expenditures (up 45% and 51% y-o-y, respectively) ahead of the October presidential elections.

¶11. (SBU) Excluding the one-time pension funds transfer, the primary fiscal surplus would have only reached ARP 3.8 billion, 2.4% lower than in May 2006. According to analysts from Argentine think tanks FIEL (Fundacion de Investigaciones Economicas Latinoamericanas) and Ecolatina, the reform of the pension system will result in transfers of ARP 8 billion (\$2.6 billion) in 2007, or about 1% of GDP. This will allow the primary fiscal surplus to remain at about 3.5% of GDP, as in 2006. Otherwise it would fall to the range of 2.5% of GDP. Local analysts consider that the huge revenue cushion available -- including from pension transfers -- will allow the GoA to avoid moderating its primary spending growth in the months leading to the elections.

¶12. (SBU) Note: the so called counter-reform of the pension system allows workers in the private sector to transfer back to the federal government's pay-as-you go system. The May transfer is a "stock" transfer, (accumulated savings), which has a one-time impact, as compared to a monthly "flow"

transfer. It is also interesting to note that the transfer reflects the composition of the pension fund portfolio, which is only about 5% cash and the remainder in assorted financial assets (e.g., stocks, government bonds). Therefore, a significant portion of the transfer booked as GoA revenues will not provide financing unless the stocks and bonds are sold. Also important to note is that the transfer from the private pension system to the government pay-as-go-system also creates a future liability for the GoA, as it is now responsible for making future payments to future retirees.
End Note.

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